

Office of Chief Counsel
Internal Revenue Service
memorandum

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date:

to: Michael M. Berue, Technical Advisor (LMSB:PFTG)
Section 401(k) and Similar Plan Accelerated Deductions

from: Industry Counsel [Section 401(k) Accelerated Deductions]

subject: Voluntary Disclosures - Section 401(k) Accelerated Deductions

This memorandum responds to your October 7, 2002 request for advice. This memorandum should not be cited as precedent.

Issue and Short Answer

You have inquired whether the scenario set forth below implicates the restrictions set forth in I.R.C. § 7605(b) on repetitive examinations. We have concluded that, under the facts described, the Field Examination Team's contacts with the taxpayer do not amount to an "inspection of the taxpayer's books of account" within the meaning of Section 7605(b), and thus do not implicate that Section's restrictions on subsequent examinations.

Facts

Many taxpayers, pursuant to Announcement 2002-2, disclosed to the Internal Revenue Service (prior to the April 23, 2002 cut-off date for such disclosure), their participation in transactions which, while not identical, were substantially similar to the transaction described in Revenue Ruling 90-105.¹

¹Announcement 2002-2 is the Service's penalty initiative for tax avoidance transactions (also sometimes referred to as the "disclosure initiative"). In the Announcement, the Service agreed to not assert the accuracy related penalty with respect to any underpayment of tax by taxpayers who disclosed their participation in tax avoidance transactions, and otherwise complied with the terms of the penalty initiative. Rev. Rul. 90-105 transactions (and transactions substantially similar thereto) are "listed transactions," i.e., tax avoidance transactions, within the meaning of § 1.60114T(b)(2) of the temporary Treasury regulations and § 301.6111-2T(b)(2) of the

Disclosures pursuant to Announcement 2002-2 were, for taxpayers not under examination, filed with the Office of Tax Shelter Analysis (OTSA) in the National Office. OTSA then disseminated these disclosures to the appropriate Field Office, to open an examination.

In the transaction described in Rev. Rul. 90-105, the taxpayer claimed a deduction, pursuant to the grace period provided by I.R.C. § 404(a)(6), for contributions made after the close of its taxable year but prior to the due date of its return as extended, based on compensation earned after the taxable year.² In the mid to late 1990's, various accounting firms marketed a variation on the Rev. Rul. 90-105 transaction, pursuant to which a corporation would, prior to the end of its taxable year, amend its qualified plan to provide for a "specified minimum contribution" to the plan during its plan year. Taxpayers implementing the transaction then took the position that subsequent contributions to the plan, even though made post-tax year end (and with respect to compensation earned post-tax year end), were made to satisfy a liability - the specified minimum contribution - which had been created prior to tax year end. These taxpayers then concluded that these post-tax year end contributions were therefore deductible as having been made "on account of" the preceding tax year within the meaning of Section 404(a)(6).

On July 22, 2002, the Service in Revenue Ruling 2002-46 ruled that the "specified minimum contribution" does not render contributions based on post-tax year end compensation "on account of" the preceding taxable year within the meaning of section 404(a)(6), regardless of whether the taxpayer's liability to make the contribution was fixed prior to tax year end.³ Revenue Ruling 2002-46 further provides that a change in a taxpayer's treatment of contributions to a method consistent with the ruling is a change in

temporary Procedure and Administrative regulations. See, Notice 2001-51.

²I.R.C. § 404(a) allows a deduction for contributions to qualified plans in the taxable year when paid. Section 404(a)(6), however, allows a grace period for such contributions: to the extent the contributions are made prior to the due date of the return as extended and are made "on account of" the preceding taxable year, section 404(a)(6) deems the contributions to have been made in the prior tax year.

³ The ruling also held that the described transaction is substantially similar to the Rev. Rul. 90-105 transaction under Notice 2001-51. See footnote 1, above.

method of accounting. Under the ruling, a taxpayer wishing to change its treatment of contributions to accord with the ruling must follow the automatic change in method of accounting provisions in Rev. Proc. 2002-9 (as modified by Rev. Proc. 2002-19, and as modified and clarified by Announcement 2002-17), except that the scope limitations in section 4.02 of Rev. Proc. 2002-9 will not apply, provided the taxpayer's method of accounting for contributions addressed in the ruling is not an issue under consideration for taxable years under examination, within the meaning of section 3.09(1) of Rev. Proc. 2002-9, at the time of filing the Form 3115 with the National Office.

The change in method of accounting provisions of Rev. Rul. 2002-46 effectively permit a taxpayer not under examination to file a Form 3115 requesting a voluntary change in method of accounting for its current taxable year (which in most cases is a year subsequent to the years with respect to which it disclosed its participation in the transaction under the penalty initiative), and thereby obtain audit protection for earlier taxable years. That is, once the taxpayer files its Form 3115 pursuant to Revenue Ruling 2002-46 to make the change in method and pick up the appropriate section 481(a) adjustment in the year of change, the Service under Rev. Proc. 2002-9 as modified by Rev. Rul. 2002-46 will not adjust the accelerated contributions in prior taxable years.

Many taxpayers who disclosed their participation in these transactions under Notice 2002-2 also filed Forms 3115 with the National Office, pursuant to Rev. Rul. 2002-46. When contacted for examination by the Field pursuant to the disclosure notification, these taxpayers furnish the Exam Team a copy of the Form 3115 and assert the audit protection afforded by Rev. Rul. 2002-46 and Rev. Proc. 2002-9 with respect to the disclosed transaction. The Examination Team then notifies the taxpayer that, having reviewed the Voluntary Disclosure statement submitted pursuant to Announcement 2002-02 and the related Form 3115, no further action will be taken regarding the matter.

You have requested our advice regarding whether the facts described constitute an "inspection of a taxpayer's books of account," within the meaning of I.R.C. § 7605(b), thus restricting the Service's ability to, in the future, examine the taxable years with respect to which disclosure was made, for other, as yet unidentified, issues.

Analysis

I.R.C. § 7602, Examination of books and witnesses, provides in pertinent part as follows:

(a) Authority to summon, etc.

For the purpose of ascertaining the correctness of any return, making a return where none has been made, determining the liability of any person for any internal revenue tax or the liability at law or in equity of any transferee or fiduciary of any person in respect of any internal revenue tax . . . the Secretary is authorized -

(1) To examine any books, papers, records, or other data which may be relevant or material to such inquiry . . .

The Secretary's ability to conduct examinations pursuant to I.R.C. § 7602, while broad, is not unlimited. Section 7605(b), Restrictions on examination of taxpayer, provides that:

No taxpayer shall be subjected to unnecessary examination or investigations, and only one inspection of a taxpayer's books of account shall be made for each taxable year unless the taxpayer requests otherwise or unless the Secretary, after investigation, notifies the taxpayer in writing that an additional inspection is necessary.

Section 7605(b) requires that the Service notify a taxpayer in writing if it intends to conduct more than one "inspection of (its) books of account." See, e.g., Rev. Proc. 94-68, 1994-2 C.B. 803 (setting forth conditions under which a case closed after examination may be reopened to make an adjustment unfavorable to the taxpayer, and examples of contacts which do not constitute an examination or inspection).⁴

Cases interpreting Section 7605(b) make clear that, consistent with the literal language of the statute, its restrictions on additional examinations are triggered only in the event of an actual physical inspection of the taxpayers books and records. The Service's opening of an examination as a result of the taxpayer's disclosure of a transaction substantially similar to that described in Revenue Ruling 90-105, incident to which the taxpayer informs Exam that it has filed a Form 3115 requesting a voluntary change in method of accounting to follow the position set forth in Revenue Ruling 2002-46, as a result of which Exam closes the matter without further action, does not implicate the provisions of Section 7605(b).

⁴Rev. Proc. 94-68 is the most recent revenue procedure addressing section 7605(b). See, e.g., Miller v. Commissioner, T.C. Memo. 2001-55.

Even the review of a taxpayer's income tax return and accompanying schedules does not constitute an "inspection of a taxpayer's 'books of account'" within the meaning of section 7605(b). Benjamin v. Commissioner, 66 T.C. 1084 (1976), citing Guerkink v. United States, 354 F.2d 629 (7th Cir. 1965) and Pleasanton Gravel Co. v. Commissioner, 64 T.C. 510 at 527-529 (1975). See also, Curtis v. Commissioner 84 T.C. 1349 (1985) (to same effect). In the situation described herein, the Exam Team in all likelihood will not even have secured the taxpayer's tax return, since upon opening of the examination the taxpayer will have apprised the Exam Team that it is changing its method of accounting to comport with the Service's position in Rev. Rul. 2002-46. "Inspection" of a taxpayer's "books of account" within the meaning of I.R.C. § 7605(b) requires at a minimum that the Commissioner "have access to and physically view a taxpayer's books and records." Benjamin, supra at 1098; Curtis, supra, at 1352. See also DeMasters v. Arend, 313 F.2d 79 (9th Cir. 1963) ["Legislative history confirms that Congress was primarily concerned with protecting taxpayers from examinations which were 'unnecessary' in the sense that they followed prior investigations of the same matter which had established that there was no basis for liability; stricture against 'unnecessary examinations' was designed to prevent uselessly repetitive examinations and investigations not relevant to possible tax liability, not to nullify the preceding sections of the Code."]; Gardner v. Commissioner, T.C. Memo. 1976-337 [Commissioner's reopening of examination of 1968 return after having sent letter stating that 1968 return had been accepted as filed was not a second examination of the books of account within meaning of section 7605(b) and did not require written notice]; Digby v. Commissioner, 103 T.C. 441 (1994) (no second inspection of taxpayer's books of account for earlier, already examined taxable year, where inspection of records from subsequent taxable year led to adjustment in earlier taxable year). Since, under the scenario described, the Exam Team will most probably not even have reviewed the taxpayer's income tax return, let alone any books and records, it is abundantly clear that its contact with the taxpayer as a result of the Voluntary Disclosure will not amount to an "inspection of books of account" within the meaning of section 7605(b).

Since the Service's contact with the taxpayer does not implicate the restrictions on subsequent inspections of the taxpayer's books of account, this contact will not constrain the Service's ability, should the need arise, to examine the disclosing taxpayer for other, as yet unidentified, issues, for the taxable

year for which the Rev. Rul. 90-105 transaction was disclosed.⁵

⁵ At the time you solicited our views with respect to the issue addressed herein, you provided a copy of a letter which a Team Manager had drafted to conclude the Service's inquiry into the matter disclosed, under the circumstances described. The text of this letter (which follows) is consistent with our opinion herein: "After review of your Voluntary Disclosure statement pursuant to Announcement 2002-02 dated xx/xx/02 and the related Form 3115 - Application for Change in Accounting Method dated xx/xx/02, no further action will be taken regarding this matter at this time. Please note that this review does not constitute an examination of any return for the tax years described in the Voluntary Disclosure. If you have any questions regarding this matter, please do not hesitate to contact me. (Signed, Team Manager.)"

Please do not hesitate to contact the undersigned should you have any further questions regarding this matter.

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By: _____
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